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External debt sustainability and development

Report of the Secretary-General

Summary

The present report, submitted pursuant to General Assembly resolution 65/144, reviews recent developments in the external debt of developing countries with a special focus on policies aimed at avoiding debt crises and the role of credit rating agencies.

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I. Introduction

1. The present report, which is submitted to the General Assembly in accordance with the request of the Assembly in its resolution 65/144, includes a comprehensive analysis of the external debt situation and debt-servicing problems of developing countries and countries with economies in transition. It describes new developments and trends in external debt and related areas of development finance, discusses the role of credit rating agencies and provides a basis for deliberation on related policy issues.

II. Recent trends and challenges

2. The dollar value of the total external debt of developing countries and countries with economies in transition stood at approximately $3.5 trillion by the end of 2009 (see annex). The growth rate of total external debt slowed from 8 per cent in 2007-2008 to 3.5 per cent in 2008-2009. Although, 2010 data from the World Bank Debtor Reporting System are not yet available, the United Nations Conference on Trade and Development (UNCTAD) secretariat estimates that debt grew by approximately 10 per cent during 2010, bringing total external debt to nearly $3.9 trillion. This large increase in the dollar value of external debt was partly due to gyrations in the value of the United States currency in 2010, which depreciated by approximately 6 per cent in effective terms.

3. Even though the dollar value of debt increased, robust output and export growth in the developing world led to a decrease in debt ratios, reversing the deterioration witnessed in the 2008-2009 period. The average debt service to export ratio of developing countries decreased from 12 per cent in 2009 to an estimated 9.2 per cent in 2010, and their average external debt to gross national income (GNI) ratio decreased from 21.8 per cent in 2009 to an estimated 20.2 per cent in 2010.

4. Improvements in debt ratios are driven by the fact that developing countries, as a group, are running large current account surpluses and have thus become net exporters of capital. Recent estimates indicate that developing countries provided a net transfer of financial resources to developed countries of approximately $557 billion during 2010.[1] Even though, on average, developing countries do not need foreign financing, private capital continues to flow towards selected emerging market countries. Net private capital inflows to such countries are estimated to have surpassed $900 billion in 2010, a 50 per cent increase over 2009 flows, and are projected to reach $1 trillion by 2012.

5. Balance of payments accounting requires that current accounts and capital accounts sum to zero. Therefore, a situation in which developing countries run a current account surplus and receive net private capital inflows requires large official outflows to balance them out. The rapid accumulation of international reserves is the outcome of this process. In 2010, total international reserves of developing countries surpassed $5.5 trillion, corresponding to 1.5 times the total external debt of developing countries.

[1] *World Economic Situation and Prospects 2011* (United Nations publication, Sales No. E.77.11.C.2).

6. Private capital flows of the "carry trade" type continue to be attracted by high interest rates, which are not caused by the scarcity of funds but rather by the attempts of central banks to fight inflation in growing economies.[2] It is sometimes argued that large private inflows to developing countries signal the strength of the receiving economies, although such flows are often a symptom of a poorly functioning international financial architecture, which can result in a situation in which investors based in the developed economies lend to private borrowers and central banks in emerging market countries, who then lend back to the public sector of the developed economies. Such enormous gross capital flows do not serve to promote capital accumulation or structural transformation. On the contrary, they may lead to a new form of the "Dutch disease",[3] where the exchange rate value is driven by speculative capital flows rather than being determined by market fundamentals. Misaligned exchange rates undermine national efforts to develop the manufacturing industry and to diversify domestic production and exports.

7. This new form of the Dutch disease is more dangerous than the traditional one, which was driven by commodity booms. The traditional form leads to distortions but also increases the wealth of a country, whereas the financial form is driven by debt flows that need to be repaid and thus have no direct effect on a country's net wealth (since short-term flows are rarely invested in productive activities). Therefore, in addition to creating the typical distortion associated with the Dutch disease, "carry trade" activities also plant the seed for a currency crisis, which takes place when investors decide to suddenly abandon a given target currency. When such a crisis hits, exchange rates tend to run out of control and central banks attempt to stabilize the situation by increasing interest rates, a procyclical policy that ends up causing further damage to the real economy.

8. The trends described above are mostly driven by the large emerging market countries, a factor which masks the fact that there is substantial heterogeneity among developing countries. The majority of developing countries are still net importers of capital. In 2009, there were 117 developing countries (out of 158 for which data were available) with a current account deficit; 81 of those 117 countries had a current account deficit greater than 5 per cent of their gross domestic product (GDP). In 2010, the number of developing countries with a current account deficit dropped slightly, to 114, of which 72 had a current account deficit greater than 5 per cent of GDP. Almost all least developed countries (43 out of 49) ran current account deficits in 2009 and 2010. More than two thirds of those countries (37 in 2009 and 33 in 2010) had current account deficits greater than 5 per cent of GDP.

Regional trends

9. In 2010, debt service represented less than 4 per cent of exports in East Asia and the Pacific, more than 22 per cent of exports in Eastern Europe and Central

[2] United Nations Conference on Trade and Development, *Trade and Development Report* (2006, 2007, 2008, 2009 and 2010).

[3] According to Ebrahim-zadeh, Christine, "Back to Basics — Dutch Disease: Too much wealth managed unwisely" (*Finance and Development*, March 2003, Volume 40, No. 1), although the disease is generally associated with a natural resource discovery, it can occur from any development that results in a large inflow of foreign currency, including a sharp surge in natural resource prices, foreign assistance and foreign direct investment.

Asia, 5.3 per cent in sub-Saharan Africa, 5.8 per cent in the Middle East and North Africa, 6.8 per cent in South Asia and 14 per cent in Latin America and the Caribbean. External debt is close to 40 per cent of GNI in Eastern Europe and Central Asia and 12 per cent of GNI in East Asia and the Pacific, approximately 14 per cent in Middle East and North Africa, 18 per cent in sub-Saharan Africa and South Asia and 24 per cent in Latin America and the Caribbean. Even in the presence of large regional differences, debt ratios have improved in almost all developing regions. The largest drop in the external debt to GNI ratio was in Eastern Europe and Central Asia (5 percentage points drop) followed by sub-Saharan Africa (3.5 percentage points), East Asia and the Pacific, South Asia and the Middle East and North Africa. Latin America and the Caribbean is the only region for which the external debt to GNI ratio remained at its 2009 level. International reserves are particularly large in East and South Asia (more than twice total external debt), but they are also substantial in other developing regions. All regions have reserves that exceed their short-term external debt by at least three times and that cover at least 50 per cent of their total external debt.

10. Although improvements in debt indicators, current account surpluses and high reserve coverage can increase the resilience of developing countries to external shocks, these figures represent averages that mask large cross-country differences. Debt ratios vary across countries and reserve coverage is limited and rapidly decreasing in some small and vulnerable economies.

11. In sub-Saharan Africa, higher commodity prices, particularly for oil, helped to narrow both fiscal and current account deficits in 2010. Average fiscal deficits to GDP decreased from 7.2 per cent in 2009 to 5.6 per cent in 2010, while average current account deficits to GDP went from 2.4 per cent to 2.3 per cent. The improvement in current account deficits varied among countries in the region, however. While oil and mineral exporters benefited from high commodity prices, and also experienced a marked improvement in their current accounts, the current account deficit widened in many oil-importing countries. The situation is particularly worrisome for some small African countries which are expected to register large current account deficits in 2011.[4] Although, international reserves have remained broadly stable in 2010 compared to 2009, 10 African countries had reserve coverage at levels well below the 3-months of imports threshold.[5]

12. Average economic growth of countries in Asia and the Pacific continued to outperform that of the rest of the developing world. The region continues to run large current account surpluses. Remittances, which are particularly important for some small economies in the region, grew by more than 6 per cent during 2010. While Asia was not particularly affected by the global crisis, there are some downside risks. The region's exports may suffer from a protracted crisis in Europe and by second-round effects from higher oil prices, which could lead to a slowdown of global demand. Moreover, large and volatile capital inflows remain a source of risk for several Asian economies, especially for those with large current account deficits. Many Pacific Island countries recorded widening current account deficits

[4] Oil-importing countries emerging from conflict have the largest current account deficits. Current account deficits are expected to increase by more than 5 per cent of GDP in Cape Verde, Lesotho, the Comoros and Sao Tome and Principe.

[5] Benin, Djibouti, Gambia, Liberia, Malawi, Mauritania, Sierra Leone, the Sudan, Togo and Zimbabwe.

for 2010. These countries, as a result of their marked dependence on food and fuel imports, remain vulnerable to rising commodity prices.

13. Notwithstanding recent increases in Government spending, oil exporting countries in the Middle East and North Africa are expected to strengthen their fiscal and external balances as a result of strong growth in certain countries in 2011. In contrast, the economic outlook for oil importers is mixed. Some countries are benefiting from greater trade and remittance receipts from oil exporters within the region, but the risks to those countries are mainly on the downside. The near-term economic outlook is subject to unusually large uncertainties stemming from recent political unrest. Further deterioration of investor confidence could leave Governments short of needed financing, especially in countries with growing current account deficits owing to sudden drops in tourism and export revenues.

14. In 2010, average external debt ratios of countries in Latin America and the Caribbean registered a small improvement. However, several countries in the region are registering widening current account deficits as import growth outpaces export growth, even for commodity exporters that are benefiting from higher commodity prices. High commodity import prices are a source of vulnerability for most small Caribbean island countries, which are already in a situation of high public and external debt.[6]

III. Debt situation of the least developed countries

15. The least developed countries tend to have high external debt levels. In 2009, the total debt of the 49 countries belonging to the group stood at 32 per cent of the group's GNI, 10 percentage points higher than the average for all developing countries. Estimates for 2010 indicate that the average debt of the least developed countries will drop to 28 per cent of GNI, 8 percentage points higher than the estimate for the average developing country. Because a large share of the debt of the least developed countries has been arranged on concessional terms, debt service costs tend to be lower for them. In 2009, the average debt service for the least developed countries was 6 per cent of exports compared to 12 per cent for the average developing country.

16. The global recession ignited by the collapse of Lehman Brothers led to a large increase in the total external debt of the least developed countries, which increased from $144 billion in 2007 to $162 billion in 2009, although it is estimated to have dropped to $156 billion in 2010. In terms of the share of exports, total external debt increased from 84 per cent in 2008 to 112 per cent in 2009, but is estimated to have declined to 89 per cent in 2010. While the situation is now improving, the pace of recovery has been uneven and economic growth has not yet returned to pre-crisis levels for all countries.

17. Strong policy buffers contributed to the resilience of the least developed countries during the crisis. However, these countries are rapidly running out of fiscal policy space as countercyclical Government spending increased public debt, reduced international reserves and widened current account deficits.[7] According to the most recent debt sustainability analysis exercises, three least developed

[6] Trinidad and Tobago is an exception.

[7] International Monetary Fund, *Fiscal Monitor*, April 2011.

countries are in debt distress and another 11 are at high risk of debt distress.[8] It is important, therefore, not to be misled by the resilience of these countries as a group, or to ignore cross-country differences. In the light of the vulnerability of the least developed countries to external shocks, the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund (IMF) has requested a refinement of the tools to assess debt sustainability in low income countries, and intends to explore avenues to help them to improve their ability to manage under circumstances of high volatility.[9]

18. Rebound in GDP growth will be essential if the least developed countries are to return to the pre-crisis path towards greater debt sustainability. Countercyclical policies, debt relief and official development assistance (ODA), foreign direct investment (FDI) and remittance flows have been important for recovery. However, the "Asia effect" was the main driver of external demand, and of the economic rebound, for those least developed countries that export commodities.[10] Downside risks still abound, as many countries remain vulnerable to the recent surge in food and fuel prices. Debt problems in the euro zone could negatively impact exports to Europe, a main trading partner for most non-oil-exporting countries in sub-Saharan Africa.

IV. Preventing public debt crises

19. The design and implementation of policies aimed at avoiding public debt crises must take the origins of the crises into consideration. The basic public debt accumulation equation states that the change in the stock of public debt is equal to the fiscal deficit accumulated during the period under consideration. Practitioners know that this definition rarely holds true, and add to the deficit a residual entity which reconciles the change in debt with the deficit. Since the debt is a stock variable and the deficit is a flow variable, this residual entity is usually called "stock flow reconciliation". Although, practitioners know about the stock flow reconciliation, this residual term rarely appears in descriptions of the evolution of public debt because it is often assumed to be quantitatively small and mostly driven by measurement error. In fact, this is not the case. Over the 1985-2005 period, there were many episodes in which the stock-flow reconciliation was the largest determinant of debt growth, much more important than the recorded budget deficit.

A. The origin of public debt crises

20. A few examples of sudden debt explosions can be instructive. At the end of 2007, Iceland's total Government debt was approximately 380 billion krónur (29 per cent of GDP). By the end of 2010, the total public debt of Iceland was close to 1,850 billion krónur (about 115 per cent of GDP). This debt explosion was not the

[8] As of May 2011, the least developed countries in debt distress include: the Comoros, Guinea and the Sudan. Countries at high risk of debt distress include: Afghanistan, Burkina Faso, Burundi, the Democratic Republic of the Congo, Djibouti, the Gambia, Guinea-Bissau, Haiti, the Lao People's Democratic Republic, Sao Tome and Principe and Yemen.

[9] International Monetary and Financial Committee communiqué, 16 April 2011, see http://www.imf.org.

[10] Economic Commission for Africa, *Economic Report on Africa 2011*.

outcome of an irresponsible fiscal policy. In 2008, Iceland ran a budget deficit of 0.5 per cent of GDP and in 2009 and 2010 it ran budget deficits of 9 and 12 per cent of GDP, respectively. The accumulated budget deficit was 22.5 per cent of GDP, but the debt-to-GDP ratio increased by 86 percentage points.[11]

21. In 2007, Ireland had a gross public debt of approximately €47 billion (25 per cent of GDP). By the end of 2010, the public debt of Ireland had increased by more than €100 billion (nearly 100 per cent of GDP). While Ireland ran a deficit of approximately €65 billion, the remaining €35 billion of debt accumulation cannot be explained by fiscal policy.[12]

22. There are also examples to consider among emerging market countries. For example, in December 1998, Brazil's net public debt stood at approximately 42 per cent of GDP; by January 1999, that ratio surpassed 51 per cent of GDP. It seems unlikely that the Brazilian Government could have run a deficit of almost 10 per cent of GDP in just one month. In the case of Argentina, at the end of 2001, public debt stood at about 50 per cent of GDP; a few months later, Argentinean public debt surpassed 130 per cent of GDP. Once again, it seems unlikely that the Argentinean Government could have run a deficit equal to 80 per cent of GDP in less than one year.

23. The drivers of the debt explosions documented above are well known. In the case of Iceland, the origin was a currency crisis, which then led to a banking crisis and finally to a public debt crisis. In the case of Ireland, the growth of public debt was driven by a banking crisis caused by a real estate lending boom. In the cases of Argentina and Brazil, the sudden increase in debt was due to negative balance sheet effects brought about by the presence of foreign currency debt.

24. These are not rare events. A study using data for up to 117 countries over the period from 1985 to 2003 shows that the stock flow reconciliation factor is an important determinant of debt growth in all developing regions.[13] The average value of this residual entity was 9.6 per cent of GDP for low income countries, 4.9 per cent of GDP for middle income countries and 0.8 per cent of GDP for high income countries. Over the same period, the average budget deficit to GDP for these three groups of countries was 4.7 per cent, 4.1 per cent, and 3.3 per cent, respectively.

25. The statistical exercise mentioned above found that the most important determinants of debt explosions are banking crises and negative balance sheet effects driven by currency depreciations in the presence of foreign currency debt.

26. Measurement error is also important. Data on the level and composition of public debt tends to be of poor quality and assembled from sources that differ from the sources used to gather fiscal data. However, if the difference between deficits and the change in debt were solely the result of random measurement error, positive errors would compensate negative errors and the stock flow reconciliation would average to zero over the long run. The data show that this is not the case and that the

[11] Even these deficits were not due to profligate fiscal policies but were a consequence of the economic crisis that followed the collapse of Iceland's largest banks. As late as 2006, Iceland ran a budget surplus which was well above 6 per cent of GDP.

[12] Again, the large deficits of 2008-2010 were driven by Ireland's economic collapse and not by explicit fiscal policy decisions.

[13] See C. F. S. Campos, D. Jaimovich and U. Panizza, "The unexplained part of public debt", *Emerging Markets Review*, vol. 7, No. 3 (2006).

long-run average of the stock flow reconciliation is positive and large. This might be due to the fact that measurement errors in fiscal accounts are non-random and that some countries systematically underreport their deficits. Increasing the transparency of fiscal accounts would contribute to solving this problem.[14]

B. Policies for preventing debt crises

27. Although debt crises do not always have a fiscal origin, there are cases in which they are indeed caused by unsustainable fiscal policies and by institutional arrangements in the capital markets that conceal the true risks of lending and borrowing activities. A transparent budget process could help to prevent the accumulation of debt beyond reasonable limits. Nevertheless, room for discretionary fiscal policy is indispensable. The ability of Governments to put countercyclical policies in place and to stabilize themselves against other shocks should be permitted in all circumstances.

28. To request all countries at all times to stick to the same critical debt level as a way to preserve debt sustainability may not be the best way to attain this objective. Governments, in their economic policy and debt strategy, have to take into account the specificities of their societies and their external constraints. For example, a country with a very high savings rate on the part of private households should try to increase its engagement in productive investment and may need a higher public debt ratio, in particular if it cannot rely on running a current account surplus that would compensate for the savings of the domestic agents.

29. A large fiscal deficit is the only sensible response to rapid deleveraging by the private sector. Governments that want to prevent debt explosions should thus put in place policies aimed at preventing the build-up of private sector debt, which is usually followed by financial catastrophe and which may lead to widespread banking crises. This is especially important if debt accumulation is not driven by the need to finance investment projects but used to finance speculative activities. Tighter financial regulation, higher capital requirements for banks and capital controls are useful instruments for limiting excessive risk taking by the private sector.

30. Currency mismatches are another source of debt crises. Countries that need to balance their external accounts and have a large share of foreign currency debt face difficult trade-offs. In the absence of the positive terms to be gained through trade shocks, currency depreciation is the least painful way to restore external sustainability. However, in the presence of foreign currency debt, a depreciation can lead to a sudden jump in the debt-to-GDP ratio, and possibly to a debt crisis. In order to find a solution to this problem, one should start by recognizing that it is during economic booms that countries sow the seeds of future crises. In periods of global optimism, capital inflows flood into developing countries, which are often unable to restrict the amounts. Different sectors within such countries often go on a borrowing binge. This behaviour not only leads to a rapid accumulation of external debt but often to an appreciation of the real exchange rate and to large external imbalances. When the external imbalance becomes too large, foreign investors start

[14] The unexplained part of debt may also be linked to the inability of Governments to keep track of and report on their contingent liabilities.

pulling money out. However, because of their large foreign currency debt, countries often adopt policies aimed at limiting outflows or even attracting more capital, making the problem even more difficult to solve. In the end, the inevitable happens, capital leaves the country, its currency collapses and a debt crisis begins.

31. The solution to this trade-off requires a change of behaviour during "good times", with less external debt, more reserves and policies aimed at limiting currency appreciation. This is exactly what the largest emerging market countries have been doing since the late 1990s.

32. External shocks, which are another cause of debt explosions, can take the form of natural disasters, rapid changes in a country's terms of trade or a sudden tightening of external financial conditions. Countries can deal with these shocks by "self-insuring" through the accumulation of international reserves. One problem with self-insurance is that not all countries can afford to do it (this is especially a problem for low income countries). Moreover, while this policy is rational for each individual country, the world as a whole cannot run a current account surplus. It would thus be desirable to have a global policy aimed at addressing the global imbalances.[15]

V. Role of credit rating agencies

33. The Asian financial crisis of 1997-1998 ignited a debate on the role and effectiveness of credit rating agencies. The issuance of top investment grades for a number of structured products and their subsequent rapid downgrade during the 2007-2009 financial crisis restarted the debate on the methodology used by such agencies.[16] The European sovereign debt crisis of 2010 came at a time when confidence in the agencies had already been shaken by previous rating debacles.

34. The theoretical rationale for the existence of credit rating agencies is based on the fact that there is an asymmetry of information between lenders and borrowers with regard to the creditworthiness of the latter. In order to overcome this problem, there is a need for the existence of independent institutions to supply the information on the creditworthiness of borrowers to the capital market. This type of information is particularly important for medium- and small-sized investors who do not have the resources or the capacity necessary to evaluate the creditworthiness of various issuers.

35. Credit rating agencies should also encourage corrective measures by borrowers through their monitoring services. Such a monitoring system is supposed to provide stability to the financial system, as borrowers have an incentive to prevent the downgrading of their debt and the associated increase in their borrowing costs.

36. Credit ratings also play an important role in financial regulation. Rating decisions affect the composition of the portfolio of banks and institutional investors

[15] For such a proposal see the UNCTAD *Trade and Development Report 2009* (United Nations publication, Sales No. E.09.II.D.16).

[16] According to IMF estimates (IMF, *Global Financial Stability Report*, October 2010), more than 75 per cent of mortgage-related securities that were rated AAA before the crisis dropped to below investment grade as the financial crisis unfolded.

because credit ratings have an impact on the banks' capital charges and on the type of debt instruments that can be held by certain types of institutional investors.[17]

37. There are two possible reasons why credit rating agencies may increase financial instability. First, a rapid downgrading of previously investment grade instruments may lead to forced selling of those instruments, which amplifies the funding problems of the downgraded borrowers. Moreover, if rating agencies are overzealous in downgrading borrowers that are facing funding problems, they may amplify the original problem and push the borrowers towards default. Second, changes in the ratings of systemically important borrowers may have spillover effects, leading to an increase in borrowing costs even for borrowers in the same asset class whose credit rating has not changed. This contagion effect may be due to the fact that investors have little faith in the stability of ratings and may decide to sell in anticipation of possible downgrades in other countries. Rating agencies are thus unable to calm markets by confirming the positive credit rating of countries not directly affected by debt problems. This represents a policy challenge for developing countries as the cost of borrowing can suddenly increase without any of the fundamental variables showing deterioration.

38. To alleviate some of these problems, credit rating agencies have adopted a system of "outlooks" and "reviews" to warn the market of potential changes in credit ratings. In principle, the introduction of such a system is an improvement over previous practices as it applies pressure on the borrower to introduce corrective measures to avoid a downgrade. Nevertheless, markets are forward looking, and changes in outlook may increase borrowing costs and lead to a further deterioration of the debt position, possibly leading to a self-fulfilling prophecy and an actual downgrade.

39. Under current practices, issuers pay for the rating of securities, or in the case of countries for sovereign ratings. This model produces incentives for borrowers to do business with the agency that will give the best credit rating. As credit rating agencies have no liability in case the market proves them wrong in the future, they have an incentive to stretch the credit rating upwards as much as they can in order to win new business or to maintain existing clients.

40. The misalignment of incentives in the credit rating industry has generated two types of reactions. Some take a radical view and suggest that the regulatory use of ratings should be eliminated and that market-based discipline is sufficient to guarantee the stability of the financial system. Others argue that eliminating the regulatory role of credit rating agencies is equivalent to throwing the baby out with the bath water. Those who share this view acknowledge the potentially useful role of credit rating agencies for regulatory purposes and recognize that market-based discipline does not always work well, especially if the ultimate risk is not borne by those (such as asset managers) who choose the composition of a given portfolio of assets.[18]

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[17] Certain institutional investors are precluded from holding securities rated below investment grade. Central banks use credit ratings to determine securities that will be accepted as collateral for providing liquidity to commercial banks. For commercial banks, capital requirements depend on the credit rating of their assets.

[18] Elkhoury, M. (2008), "Credit rating agencies and their potential impact on developing countries", UNCTAD/OSG/DP/2008/1.

41. Problems linked to rating inflation could be allayed by developing payment models that provide better incentives for more accurate ratings. One possibility would be to return to investor-paid ratings financed through a transaction tax. A more radical proposal would be to nationalize the agencies. But nationalization would generate conflicts of interest, especially in the rating of sovereign and quasi-sovereign entities. A less radical form of intervention is to subject rating agencies to regulatory oversight and to publish rating performance on a regular basis.[18]

42. One way to provide the rating industry with the right incentives is to require issuers who want to have their instruments listed in a given exchange to pay a listing fee (possibly based on the complexity of the instrument), which will then be used to hire a credit rating agency (if the securities are not traded, the same mechanism can be applied by clearing houses or central depositaries).[19] Such a procedure breaks the commercial link between the issuer and the rating agency and eliminates the conflict of interest that leads to rating inflation. The issuer would still have to provide information to the rating agency but would not be allowed to remunerate it. As this procedure may not provide incentives to put "effort" into the rating exercise (yielding unbiased but inaccurate ratings), it would be possible to design incentive schemes by matching ratings with observable ex post facto outcomes.

43. While the incentive problem seems to be of paramount importance in explaining rating failures for privately issued securities, the failure of sovereign debt ratings probably has more to do with insufficiently developed methodology. The Asian crisis has shown that a number of variables that were not judged to be important in determining the credit rating of countries before the crisis, such as the level of the real exchange rate, short-term debt and contingent liabilities, were crucial in explaining the events that unfolded. Although a number of these elements have subsequently been included in assessing the credit rating of sovereign debt, it is still not clear what weights are assigned to different variables by credit rating agencies. Furthermore, as a crisis unfolds, correlations between variables that existed prior to the crisis tend to break down, making the model on which the rating was based obsolete. The way forward would necessitate greater transparency on the part of the credit rating agencies over their methodology and a public debate on ways to improve modelling risk. In this regard, the General Assembly, in its resolution 61/188, called upon the international financial and banking institutions to consider enhancing the transparency of risk rating mechanisms and noted that sovereign risk assessments made by the private sector should maximize the use of strict, objective and transparent parameters, which could be facilitated by high-quality data and analysis.

VI. Debt relief and official development assistance

A. Progress in the implementation of the Heavily Indebted Poor Countries and the Multilateral Debt Relief Initiatives

44. From mid-2010 to mid-2011, progress in the implementation of the Heavily Indebted Poor Countries Initiative continued to move forward, with four additional

[19] Mathis, J., Mc Andrews, J. and Rochet J. C. (2009), "Rating the Raters: Are reputational concerns powerful enough to discipline rating agencies?", *Journal of Monetary Economics*, vol. 56, No. 5.

countries reaching the completion point (the Democratic Republic of the Congo, Guinea-Bissau, Liberia and Togo) and one reaching the decision point (the Comoros). This means that 32 of the 40 eligible countries have now completed the initiative. All the countries that reached the completion point have benefited from additional debt relief under the Multilateral Debt Relief Initiative.[20] The remaining countries that have yet to complete the initiative include four countries that have reached the decision point and four eligible heavily indebted poor countries that have yet to begin the process.

45. While this progress is encouraging, there is concern that a number of post-completion point heavily indebted poor countries are continuing to show signs of debt distress. Of the 32 countries that have reached the completion point, 8 were deemed to be at high risk of debt distress and 11 to be at moderate risk of debt distress in their last debt sustainability analysis (dated 15 May 2011). The percentage of post-completion point countries at low risk of debt distress (40 per cent of the total) is not much higher than the share of other low income countries that are not part of the Heavily Indebted Poor Countries Initiative at low risk of debt distress (38 per cent of the total).[21]

46. As the Heavily Indebted Poor Countries Initiative winds to a close, solutions to addressing persisting debt problems of developing countries must be explored. It should be noted that there are eight least developed countries classified as being at high to moderate risk of debt distress that did not benefit from the Heavily Indebted Poor Countries or Multilateral Debt Relief Initiatives. Solutions should not therefore be restricted solely to countries that have benefited from the Heavily Indebted Poor Countries Initiative. There is also the thorny issue of domestic debt. In the case of the Gambia, a country that has received substantial debt relief, 20 per cent of Government revenues are used for interest payments on debt, of which 80 per cent is directed to payments for domestic debt.

Official development assistance

47. In 1970, the General Assembly adopted resolution 2626 (XXV) on the "International Development Strategy for the Second United Nations Development Decade", which stated that "... each economically advanced country will progressively increase its official development assistance to the developing countries and will exert its best efforts to reach a minimum net amount of 0.7 per cent of its gross national product at market prices by the middle of the Decade." After four decades, only a handful of donor countries have reached the 0.7 per cent target.

48. Over the past decade, the global discourse in support of the delivery of assistance to developing countries has remained positive. In 2000, Member States adopted the Millennium Development Goals, which outlined eight global actions to reduce global poverty by 2015. Donors reaffirmed their commitment to increasing

[20] The Multilateral Debt Relief Initiative provides full debt relief (100 per cent cancellation) from their outstanding multilateral debt claims to IMF, the International Development Association (IDA), the African Development Fund (AfDF) and the Inter-American Development Bank (IDB).

[21] There are 29 low income countries that are not members of the Highly Indebted Poor Countries Initiative. Of these 29 countries, 11 are at low risk of debt distress (see http://www.imf.org).

aid flows in the 2002 Monterrey Declaration, the outcome of the International Conference on Financing for Development. In 2005, the Group of Eight (G-8) countries issued the Gleneagles communiqué, which underlined the commitment of the members of the G-8 and other donors to increase assistance to developing countries and to double aid to Africa by 2010, thus increasing ODA to Africa by $25 billion a year. The Organization for Economic Cooperation and Development (OECD) estimated that these commitments would increase aid to developing countries by $50 billion a year by 2010, relative to 2004 levels.[22] Building upon those commitments, at the 2005 World Summit, held at United Nations Headquarters, Member States reiterated their determination to ensure the timely and full realization of the development goals and objectives agreed at major United Nations conferences and summits. In particular, donors reaffirmed their commitments to increase aid to developing countries and to reach the 0.5 per cent ODA to GNI ratio by 2010 and 0.7 per cent ratio by 2015.[23]

49. Unfortunately, actual delivery of ODA never came close to matching those commitments. In 2010, ODA delivered by donors to the OECD Development Assistance Committee reached $129 billion, constituting a 6.5 per cent increase over 2009 in nominal terms and a $21 billion increase with respect to 2005, marking the highest nominal level of ODA to date. The figures, encouraging at first glance, present a more dismal picture of aid efforts when the evolution of exchange rate, inflation, and growth are taken into account. The calculations of the UNCTAD secretariat suggest that controlling for inflation and the depreciation of the United States dollar removes between $5 billion and $15 billion (depending on the assumptions used) from the $21 billion increase. Therefore, the "real" increase of aid flow over the period from 2005 to 2010 is between 25 to 70 per cent lower than the nominal increase reported in official figures.

50. Although donors have remained committed to the neediest countries, they are not meeting the ODA targets on which they have repeatedly agreed. While some donors have surpassed the 0.7 per cent of ODA to GNI target, most donors are still far from achieving it. In fact, in 2010, average ODA was equal to 0.32 per cent of the GNI of donor countries, which is exactly the same value of ODA to GNI as in 2005, when donors were renewing their commitments to increasing aid.[24]

51. Not only have donor countries not met their commitments to increase aid, it is possible that the global financial and economic crisis will lead to a reduction of aid flows. Many donor countries, facing increasing pressure to cut budgets owing to combinations of increased spending requirements and lower tax revenues, reduced their ODA contributions in 2010.[25] According to the *2010 OECD Report on Aid Predictability: Survey on Donors' Forward Spending Plans, 2010-2012*, the growth rate of aid is likely to slow in the coming years.

52. This decline will have negative implications for low income countries and small and vulnerable economies. Debt relief and other forms of ODA provide important sources of financing that are essential for countries pursuing the Millennium Development Goals and other internationally agreed development goals,

[22] Gleneagles communiqué, paras. 24 and 28.

[23] General Assembly resolution 60/1, paras. 17 and 23 (b).

[24] OECD, Statistics on Resource Flows to Developing Countries, table 4, "Net Official Development Assistance by DAC Country", see www.oecd.org.

[25] OECD, "Development aid reaches an historic high in 2010", see www.oecd.org.

in particular for countries with narrow tax bases and unpredictable revenue streams. The World Bank reported in its publication, *Global Monitoring Report 2011: Improving the Odds of Achieving the MDGs*, that few of the 40 low income countries are on track to meet the Millennium Development Goals by 2015. Two thirds of developing countries are on track to meet key targets for reducing poverty and hunger, although the world is lagging behind in health-related development goals, including child and infant mortality and access to sanitation.

Paris Club activities

53. Of the seven Paris Club meetings held since July 2010, all but one was devoted to treating the debt of the heavily indebted poor countries.

54. In July 2010, Guinea-Bissau rescheduled the arrears on its Paris Club debt, including maturities falling due between December 2009 and December 2012, under the Cologne terms. The country reached the completion point under the Heavily Indebted Poor Countries Initiative at the end of 2010, opening the way for a debt stock treatment under the Initiative in May 2011. On a bilateral and voluntary basis, Paris Club creditors decided to go beyond the standard debt cancellation under the Initiative and wrote off an additional $27 million of Guinea-Bissau's official bilateral debt.

55. Comoros reached the decision point in June 2010, paving the way for a meeting of the Paris Club to consider debt relief for the country in August 2010. Maturities falling due between June 2010 and June 2012 were treated under the Cologne terms, and the previously rescheduled debt benefited from an additional reduction of 50 per cent of debt service falling due, as was agreed at the 2009 meeting.

56. In September 2010, Antigua and Barbuda came to the Paris Club for the first time. Creditors agreed to treat about 85 per cent of the debt service falling due during the three-year consolidation period, 2010-2013, under the Club's "classic terms". The rescheduling also included roughly $98 million worth of arrears.

57. Following the attainment of the completion point under the Heavily Indebted Poor Countries Initiative in June 2010, Paris Club creditors met with Liberia in September to consider the country's external debt situation. The treatment granted to Liberia was generous, reflecting the country's capacity to pay. Liberia obtained a 100 per cent write-off on its pre-cut-off date debt, including the full cancellation of late interest. Both post-cut-off non-ODA debt and short-term debt were also cancelled in full.

58. In November 2010, a Paris Club meeting was held to consider the debt situation of the Democratic Republic of the Congo after it reached the completion point in the Heavily Indebted Poor Countries Initiative in July 2010. The country's stock of debt was cancelled in line with the requirements of the Initiative.

59. In December 2010, Togo reached the completion point under the Heavily Indebted Poor Countries Initiative and met with its Paris Club creditors during the same month. It obtained a full cancellation of its pre-cut-off date debt as well as a 97 per cent write-off on its post-cut-off non-ODA debt. After the implementation of the agreed cancellations, Togo's debt to the Paris Club creditors will be reduced by about 95 per cent.

VII. Conclusions and policy recommendations

60. The majority of developing countries were resilient in the face of the global financial crisis ignited by the collapse of the subprime housing market in the United States of America. Policymakers, however, should not be complacent. Some of the least developed countries and small vulnerable low and middle income economies that suffered heavily from the effects of the global recession are quickly running out of fiscal space. They may soon be forced into a counterproductive fiscal contraction, and they face problems in dealing with high food and oil prices. Moreover, the outlook for the global economy remains uncertain and a new shock or even a slow recovery may have negative effects on debt sustainability.

61. While the majority of developing countries are still running current account deficits, many emerging market countries are running current account surpluses and facing a wall of private capital inflows and currency appreciation. This financial Dutch disease has had a negative impact on industrialization and structural change and may lead to future currency crises. It is imperative that the international community put in place a system that can limit unproductive large capital flows, which, rather than promoting economic development, are purely speculative in nature.

62. The global economic events and developments that have taken place in the past several years have been unprecedented, and as a result, much international discourse has been diverted away from the development agenda. The success of achieving the Millennium Development Goals hinges on the provision of adequate and predictable financing. The risks posed to economic growth and poverty reduction of the poorest and most vulnerable countries, as a result of the global crisis, remain. It is imperative for donors to redouble their efforts to keep their ODA commitments in order to consolidate and maintain the progress that has been made thus far and to ensure that future progress is not jeopardized.

63. Many countries that have completed the Heavily Indebted Poor Countries Initiative have been classified as being once again at high risk of debt distress. Policies aimed at guaranteeing debt sustainability will require more research aimed at providing a better understanding of why the Heavily Indebted Poor Countries and Multilateral Debt Relief Initiatives did not succeed in maintaining debt sustainability in this group of countries. There is also a group of least developed countries that did not benefit from the debt relief offered under the two initiatives. These countries have been classified as being at high to moderate risk of debt distress. It would thus be important to consider extending debt relief to those countries (and possibly to all low income countries) and to make sure that, increasingly, aid delivery to low income countries takes the form of grants.

64. Credit rating agencies play an important role in the market for sovereign debt. For developing countries obtaining a credit rating is generally desirable. However, developing countries should be aware of some shortcomings of the rating process. In his 2006 report to the General Assembly, the Secretary-General highlighted the fact that ratings could encourage countries to pursue policies "that address rather the short-term concerns of portfolio investors in order to avoid a downgrading of their rating, while not necessarily taking into account their long-term development needs" (A/61/152, para. 25).

65. Debt crises are particularly costly for the poor and other vulnerable social groups. Putting mechanisms in place to prevent such events should be a top priority item on the international agenda. The prevalence and cost of debt crises can be reduced by using innovative debt instruments, adopting domestic and international regulation aimed at reducing destabilizing capital flows and creating an effective international lender of last resort. The international community can also help by assisting developing countries in their effort to improve and strengthen their debt management capacity.

66. The outcome document adopted at the Fourth United Nations Conference on the Least Developed Countries, held in Istanbul from 9 to 13 May 2011, stated that "Long-term sustainability of debt depends on, inter alia, responsible lending and borrowing by all creditors and debtors ...". Responsible and prudent lending and borrowing is the first line of defence against the emergence of debt problems. In May 2011, following inclusive and transparent multi-stakeholder consultations, UNCTAD released a set of draft principles outlining responsibilities of lenders and borrowers in sovereign financing. Further discussion and consensus-building around this set of principles on responsible sovereign lending and borrowing would contribute to the prevention of debt crises in the future.

67. Even with the best policies, debt crises are bound to happen. It is lamentable that the international financial architecture still lacks a mechanism aimed at facilitating the resolution of sovereign insolvency and impeding litigation by providing a resolution to debt distress that is legally binding on all creditors.

Annex

External debt indicators

(In billions of United States dollars)

	All developing countries and countries with economies in transition[a]						*Sub-Saharan Africa*					
	1990-1994	*1995-1999*	*2000-2006*	*2008*	*2009*	*2010*[b]	*1990-1994*	*1995-1999*	*2000-2006*	*2008*	*2009*	*2010*[b]
Total debt stocks	1 439.5	2 026.5	2 351.5	3 425.4	3 545.1	3 891.9	191.5	226.1	210.6	195.5	199.0	196.3
Long-term debt	1 165.5	1 626.5	1 892.6	2 672.0	2 759.2	3 058.1	158.2	177.1	172.8	143.1	156.3	166.3
Private (share)	47.8	54.2	60.8	73.5	72.3	73.7	25.2	24.0	22.5	33.2	34.0	34.1
Private non-guarantee (share)	8.6	21.5	30.7	49.6	49.0	50.7	4.1	5.6	5.6	10.0	11.1	11.7
Short-term debt	238.3	334.7	387.3	728.4	733.7	833.8	26.4	41.3	31.6	48.5	36.5	30.0
Arrears	116.9	126.9	98.1	77.4	78.3		40.4	60.1	40.3	35.1	31.6	
Debt service	148.0	263.1	384.2	539.8	536.6	515.4	10.0	14.7	14.9	14.0	17.6	19.4
International reserves	238.6	517.1	1 359.8	4 156.2	4 775.7	5 485.6	15.2	25.1	57.9	156.5	156.8	158.4
Debt indicators (percentage)												
Debt service/exports[c]	21.3	21.4	17.5	9.6	12.0	9.2	18.7	15.5	9.7	3.6	6.0	5.3
Total debt/exports[c]	210.3	164.9	109.2	61.3	79.4	69.3	349.0	233.4	145.1	50.2	66.5	53.4
Debt service/GNP	4.2	5.1	5.3	3.2	3.3	2.7	5.5	4.6	3.4	1.5	2.0	1.9
Total debt/GNP	41.4	39.0	33.0	20.6	21.8	20.2	103.6	70.1	50.2	20.9	22.0	18.6
Reserves/short-term debt	100.9	156.6	333.8	577.8	657.6	669.9	56.4	61.9	178.3	319.2	431.2	521.9
Reserves/M2	13.6	18.4	22.6	31.6	29.1	27.8	13.9	22.4	29.6	38.9	32.2	28.9

	Middle East and North Africa						*Latin America and the Caribbean*					
	1990-1994	*1995-1999*	*2000-2006*	*2008*	*2009*	*2010*[b]	*1990-1994*	*1995-1999*	*2000-2006*	*2008*	*2009*	*2010*[b]
Total debt stocks	144.1	153.4	147.2	137.9	141.3	148.9	483.9	684.5	767.2	890.5	913.0	1 093.7
Long-term debt	119.8	131.2	125.1	116.9	118.7	124.4	375.4	541.6	645.7	749.9	773.1	912.7
Private (share)	33.3	23.6	31.0	36.4	34.5	36.0	64.5	74.1	78.5	82.6	80.7	88.4
Private non-guarantee (share)	0.9	1.6	4.3	5.7	5.2	5.9	11.7	30.6	35.3	44.0	44.1	52.8
Short-term debt	22.5	19.5	20.4	20.8	22.4	24.5	93.0	120.6	96.4	139.8	138.6	181.0
Arrears	8.8	11.9	9.6	0.7	0.7		43.5	12.1	20.2	30.2	32.0	
Debt service	18.2	18.4	20.0	21.7	17.8	19.5	51.8	119.9	162.4	155.6	146.7	137.9
International reserves	23.2	44.7	123.1	339.6	350.1	373.8	83.1	153.3	203.7	485.9	535.9	619.4
Debt indicators (percentage)												
Debt service/exports[c]	27.4	22.5	13.1	5.9	6.3	5.8	27.6	37.4	32.9	15.6	18.6	14.0
Total debt/exports[c]	216.4	189.4	102.5	37.4	49.8	44.7	259.1	216.0	158.7	89.4	115.5	111.0
Debt service/GNP	7.7	5.8	4.4	2.3	1.9	1.9	4.1	6.4	7.7	3.8	3.8	3.0
Total debt/GNP	61.3	48.3	33.7	14.9	15.3	14.5	38.8	36.8	37.2	21.5	23.7	23.7
Reserves/short-term debt	106.4	229.9	588.5	1 635.3	1 562.9	1 526.0	87.7	127.3	211.6	347.6	386.6	342.3
Reserves/M2	14.0	22.0	33.3	47.0	43.0	42.9	15.4	24.1	19.7	24.5	20.1	19.8

	East Asia and the Pacific						*South Asia*					
	1990-1994	*1995-1999*	*2000-2006*	*2008*	*2009*	*2010*[b]	*1990-1994*	*1995-1999*	*2000-2006*	*2008*	*2009*	*2010*[b]
Total debt stocks	300.4	509.7	557.9	756.8	825.6	903.3	137.7	154.9	184.0	318.9	340.0	378.3
Long-term debt	239.6	396.3	404.0	489.7	502.9	570.9	121.7	143.2	170.7	264.0	282.4	320.4
Private (share)	47.5	59.3	56.9	60.4	59.9	58.8	24.7	27.9	36.5	48.1	49.2	51.2
Private non-guarantee (share)	15.6	32.2	34.1	43.2	41.6	40.0	2.7	7.1	24.6	41.6	43.4	45.4
Short-term debt	59.2	105.4	143.4	266.9	322.4	332.4	9.7	8.3	11.0	49.5	48.5	57.9
Arrears	8.4	15.4	14.7	6.6	7.0		0.1	0.5	0.3	0.1	0.2	
Debt service	37.4	62.8	84.2	96.5	102.4	95.7	12.1	16.6	22.1	36.3	22.3	24.7
International reserves	89.9	218.1	665.1	2 263.7	2 777.0	3 312.1	13.6	31.3	111.9	267.1	296.5	310.9
Debt indicators (percentage)												
Debt service/exports[c]	16.5	13.6	9.7	4.1	5.2	3.7	29.7	25.3	17.4	10.0	7.1	6.8
Total debt/exports[c]	131.9	110.7	63.6	32.5	42.0	35.2	340.8	234.7	146.1	88.1	108.7	104.6
Debt service/GNP	4.6	4.4	3.7	1.7	1.6	1.3	3.2	3.2	2.8	2.4	1.3	1.2
Total debt/GNP	37.0	35.6	24.3	13.0	13.2	12.1	36.6	29.5	23.1	20.9	20.0	18.6
Reserves/short-term debt	155.3	224.9	442.2	849.2	862.7	998.2	177.6	391.4	1 102.3	540.1	611.7	537.3
Reserves/M2	13.6	14.9	19.3	28.8	27.9	27.1	8.1	13.3	21.7	26.5	24.2	20.9

	Europe and Central Asia					
	1990-1994	*1995-1999*	*2000-2006*	*2008*	*2009*	*2010*[b]
Total debt stocks	181.9	297.8	484.6	1 125.8	1 126.3	1 169.6
Long-term debt	150.8	237.0	374.4	908.4	925.8	968.5
Private (share)	60.9	55.4	73.4	91.6	90.4	90.2
Private non-guarantee (share)	5.0	14.4	42.3	71.8	70.9	70.8
Short-term debt	27.5	39.6	84.4	203.0	165.4	201.1
Arrears	15.7	26.9	12.9	4.7	6.7	
Debt service	18.5	30.8	80.7	215.6	229.7	218.1
International reserves	..	44.7	198.1	643.3	659.4	710.9
Debt indicators (percentage)						
Debt service/exports[c]	16.6	15.2	20.0	18.9	29.0	22.3
Total debt/exports[c]	164.8	144.2	127.9	100.1	142.2	119.4
Debt service/GNP	2.9	4.4	7.0	6.5	9.0	7.3
Total debt/GNP	28.6	41.7	44.7	34.6	44.0	39.1
Reserves/short-term debt	60.9	118.8	216.6	331.3	415.9	367.4
Reserves/M2	14.6	28.4	45.7	53.9	50.4	46.2

Source: UNCTAD calculations based on the World Bank (*Global Development Finance 2011*) and International Monetary Fund (IMF) (*World Economic Outlook* (online database)) data.

[a] Developing countries as defined in *Global Development Finance 2011*.

[b] 2010 values are estimates.

[c] Exports comprise the total value of goods and services exported.